PUBLIC

ATLANTIC

MICHAEL KUSHNER
SENIOR VICE PRESIDENT
BUSINESS & LEGAL AFFAIRS

TESTIMONY OF

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Senior Vice President, Business & Legal Affairs

THE ATLANTIC RECORDS GROUP

New York, NY

Before the
COPYRIGHT ROYALTY JUDGES
Washington, D.C.

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QUALIFICATIONS

My name is Michael Kushner, and I am Senior Vice President, Business and Legal Affairs of the Atlantic Records Group ("Atlantic"), which is part of the Warner Music Group. Before joining Atlantic in 2001, I had various roles in the record business, starting with PolyGram Records in 1987. Just prior to joining Atlantic, I was Senior Vice President, Legal & Business Affairs for The Island Def Jam Music Group, a division of the Universal Music Group.

In my role at Atlantic, I am primarily responsible for running the Business & Legal Affairs Department of the company. In that role, I work closely with the Chairman, President, Chief Financial Officer, head of A&R and Marketing Department. I am also responsible for A&R (Artist & Repertoire) administration, which is the department responsible for administering recording projects, and work closely with the head of A&R.

SUMMARY

I understand that the Copyright Royalty Judges, in making their determination of new royalty rates and terms under the mechanical compulsory license must consider how record companies create new works and make them available to the public, as well as record companies' creative and technological contributions, capital investments, costs and risks. The purpose of my testimony is to describe the record business as it exists in 2006, including the investments and contributions of record companies at every step in the process of making recordings available to the public, as well as the large and increasing risks we face.

The path from raw song to commercially successful sound recording product is a long and arduous one. Record companies discover talent, pull together all the many pieces necessary to create an album, design and implement extensive promotional programs, prepare the product for release in final form, manufacture it, and distribute it through every possible channel. Record companies invest substantial sums at each step in this process. It is only because of this investment that the public has access to songs, and songs enjoy a commercial life that generates income for their writers and publishers. Yet publishers do not make significant contributions to this process apart from authorizing use of their songs.

This investment by record companies is made while facing the substantial risk that we will never recoup our expenses. Although the process of making records has always been a relatively risky business, this has never been more true than today. Retail and radio consolidation have made it much more difficult than ever to break an artist. Piracy has caused a precipitous drop in sales and in big hits, so the rewards of "breaking" an artist are lower. The risks of the business have also been intensified by the transition to the digital marketplace. As a result, it is more common than ever for record companies never to recover the money spent on creating and marketing an album.

If mechanical royalty rates ever accurately reflected the investments and risks of record companies relative to writers and publishers, they certainly do not do so today. Our costs and risks have increased sharply in recent years, as have mechanical royalty rates, while the business of writing and publishing songs has changed little over time.

In my testimony, I will first provide some background about Atlantic. Second, I will describe in detail the process of creating, promoting and distributing recordings and the associated contribution and investment made by record companies. Third, I will describe the risks faced by record companies. To demonstrate this level of risk, I will provide a case study on our well-known artist Jewel, comparing the expenditures and results of her most recent album with one released only a few years before. I conclude by commenting briefly on how today's mechanical royalty rates are out of line with the investments and risks of record companies relative to writers and publishers.

DISCUSSION

I. Atlantic Records Group

Atlantic is part of the Warner Music Group ("WMG"), along with a number of other labels, including Warner Bros., Maverick, Rhino, Nonesuch, Asylum, East West, Bad Boy, Sire, and Word. Atlantic Records was founded by industry legend Ahmet Ertegun in 1947, and was originally known primarily as a rhythm & blues and jazz label. During this time, Atlantic introduced such legendary artists as Ray Charles, Aretha Franklin, and Bobby Darin. In the late 1960s, the label emerged as one of the leaders in the rock genre, with artists such as Led Zeppelin. In 2004, after an investment group led by Edgar Bronfman, Jr. bought WMG from Time Warner Inc., Elektra Records, which has a long and important history of its own, was merged with Atlantic Records to form the Atlantic Records Group. Since the consolidation of Atlantic and Elektra in 2004, the aggregate workforce of the two labels, which at its peak in 1996 was over [redacted] people, has been reduced to [redacted] employees today.

Our artists today represent a broad array of musical genres, including pop, rock, rhythm & blues, hip-hop, alternative, and a new Latin-oriented genre, reggaeton. Some of the current artists on the Atlantic label include Phil Collins, Metallica, matchbox twenty, Tracy Chapman, Missy Elliott, Jet, Kid Rock, Staind, T.I., Simple Plan, and Gnarls Barkley. Our current catalog consists of about 2,000 albums, and we release approximately 30 to 40 new albums each year. In 1999, before Atlantic Records and Elektra Records were consolidated into one label, each label independently released 43 new albums that year, or a combined total of 86 new albums.

Atlantic is a strong, well-managed company with a solid artist roster. Like our sister labels and industry competitors, however, we have had to confront and adapt to a changing business landscape. We face new challenges brought by the emerging digital marketplace, unprecedented levels of physical and online piracy, retail and radio consolidation, and competition and pricing pressures from other forms of entertainment (such as DVDs and video games). While we are experiencing growth of our online business, it has required a huge investment in new infrastructure, as well as new categories of recurring costs, and we still must maintain an infrastructure to support our declining traditional physical business. The challenges facing Atlantic and record companies generally are discussed in more detail below.

II. The Role of Record Companies in Creating, Promoting and Distributing Recordings

Record labels are the creative and economic engine of the whole music industry. The creativity of their artists, the hard, creative work of their staff, their business, promotional and distribution acumen, and the huge investments they make are what generates the income on which everyone in the industry depends. The significant involvement and investment of record companies is apparent in every step of the process of creating, promoting and distributing recordings. Although that process may vary slightly from one record to the next and differ somewhat among record companies and different genres of music, it is generally quite similar at each record label.

A. Discovering Talent and Signing Artists

Record companies play a vital role in discovering and developing talent. The first step before any record can be made is for the artist to be discovered. The A&R Department talent scouts discover new artists through various means, including listening to thousands of demonstration recordings ("demos") sent to the label each year, scouring the country and Internet for new acts, conducting market research, and meeting with artist managers. In today's difficult market, we have been forced to sign fewer new artists than we used to, and would like to.

Once the decision is made to sign an artist, the next step is for the Business & Legal Affairs Department to negotiate a recording contract with the artist. Depending on how competitive and/or complex the deal is, this process can take from days to months. Numerous factors, such as the type of artist being signed and the competitiveness of the deal, influence the terms of the agreement. For example, deal terms tend to reflect that rock albums typically cost less to produce than pop albums. Also, Atlantic often competes with other record labels to sign an act, so deal terms may include substantial up-front advances as an incentive in order to sign the artist.

Depending on the terms of each artist's contract, artists can receive various payment streams from a record company, including advances, artist royalties, mechanical royalties (if they write their own songs), and tour support. Artist royalties are usually a percentage of the wholesale price received by the record company. These royalties reflect the huge investment of time an artist makes in creating and promoting a recording, the vital role of the artist and their reputation in the success of a recording, and competition in signing popular artists. Artists also receive streams of income from other sources that are fueled by their recording career – including income from touring, merchandise and, if they write their own songs, performance royalties, synchronization license fees and sheet music sales. Record companies generally do not share in these additional revenue streams.

The relationship between record company and artist is a business partnership in which the record company fronts the costs and then it and the artist share in the reward if the record is successful. Because the record company pays the artist an advance and all the other up-front costs, artist royalties are paid only after any outstanding advances, including the cost of recording the album, have been recouped by the record label. If, as is too often the case, an album does not sell well and the advance is not recouped, the record company alone bears the loss. By contrast, mechanical royalties are generally paid to artists and other writers from the first record sold, irrespective of whether any advances have been recouped.

B. Creating Sound Recordings

After an artist is signed, the process of making the album begins. This undertaking is also the responsibility of the A&R Department, and is generally supervised by the A&R employee who signed the artist.

The A&R Department is usually responsible for selecting outside producers, in coordination with the artist and the artist's management. In the case of rock albums, that usually means selecting one producer for the entire album; in the case of urban and pop music, it usually means sifting through hundreds of "tracks" made available by producers. In the urban and pop genres, producers are generally paid by the track, and a star producer can command over $100,000 per track as a producer fee.

Selecting and/or writing the songs to be recorded is an important part of the process of creating an album. The A&R department will work with the artist, producer and sometimes outside writers to select the songs to be recorded and refine them for use in a commercial recording. The process of creating songs to be recorded varies among genres and has evolved over time. It used to be more common for the music and lyrics of a song to be created in advance, separate from the artist, and then taken into the studio and recorded. It also used to be more common for music publishers to be actively involved in promoting songs to record labels through so-called "song pluggers," but this is much less frequent today. Publishers continue to engage in some promotion in the narrow genre of country music, but is atypical in the genres of rock, urban and pop music. In the rock genre, the artists typically write their own songs, and publishers' involvement with those artist/writers tends to happen after a record company has already signed the artist. In the urban and pop genres, as stated above, the producers have largely assumed the role that used to be played by publishers; when an A&R person working in those genres is looking for songs, they call their producer contacts, not music publishers.

The growth of the producer/writer has made the creation of recordings more expensive. Record companies effectively pay for the song twice — we pay a producer fee (as stated above, sometimes in excess of $100,000 per track), and we pay mechanical royalties to the publisher of the song for every record sold. The "active" players in this process are the record companies and the producers; the publisher's role is entirely passive, collecting royalties on records which they did little or nothing to help create or sell.

The actual process of selecting and refining songs varies considerably by genre. However, in all genres, songs are created for the primary purpose of being recorded. Recording a song is the gateway for that song to generate income, and it is ultimately the hard work of the record company and the artist, as well as the substantial financial investment by the record company in recording and marketing, that gives the song a cultural and economic life.

The A&R Administration Department is usually responsible for arranging for studio time, sound engineers, and coordinating with union representatives for background musicians and vocalists. Once the studio recording session is completed, the A&R Department will work with the artist and producer to complete production and mix and master the final recording. Various edits of the recording may be completed. These days, Atlantic also engages a contractor to create different-length clips of each recording for distribution as mastertones.

C. Marketing Recordings

Even before the recording process is completed, the Marketing Department gears up to "set up" the release of the album. For the record company, most of the work and cost of releasing an album lies in marketing it. Although this part of the process is the least understood and appreciated by the general public, the efficacy, efficiency, and creativity involved in marketing artists and their recordings is no less important than the quality of the music in ensuring artists are successful. Even when a talented artist creates an impressive recording, attracting the public's attention to it is difficult and requires effort through a number of channels. Marketing takes even more effort today with the proliferation of home-recording studios, self-produced albums, and the flood of music on the Internet. Without a massive promotional effort to connect the artist and recording with an audience, the artist's and writer's creative works would not be known by the public in any meaningful way.

Music sites on the Internet demonstrates the fundamental problem for anyone who hopes to make money from music – whether writer, publisher, artist or record company. For example, eMusic offers more than 1.4 million tracks from more than 4,000 independent labels, and you probably have not heard of more than a handful of their artists. Apple's iTunes music store offers more than three million tracks. It would take decades to listen to each recording once. No one in the value chain profits from the sale of music without cutting through the clutter to reach a large paying audience. That is what record companies do best and what record company marketing efforts are all about.

Marketing recordings is a creative process that varies widely based on the genre of music and the prominence of the artist involved. For example, for pop albums, a high level of radio play combined with local promotional efforts is key, while touring is often essential for rock artists, and generating "street buzz" may be extremely important for a rap album. Whatever the focus for a particular artist, however, for a record to rise above its many competitors and become a success, there must be considerable and effective effort and investment in marketing the album. Marketing is the most expensive part of the process of making recordings available to the public.

As a first step in the Marketing Department's involvement with an album project, the Art Department works with the artist to design artwork and take photographs to be used as the album's visual imagery, including for the cover, posters, retail displays, merchandise, and other promotional material. With today's digital market, the Art Department also often works with the New Media Department to create multimedia artwork, which may include animation and video.

The product managers in the Marketing Department also become involved in the process well in advance of the album being complete. They work with the Finance Department to create a marketing budget and then create and implement marketing plans. These elaborate plans involve essential contributions from a number of different departments:

- <u>The Artist Development Department</u> plays an integral role in creating the market positioning and "branding" of an artist. It works closely with the artist to find the most effective target demographics, and helps to set up and manage touring opportunities to ensure the artists are seen by as many people as possible. Touring is an essential part of promotion, and may be the most important aspect for some artists (rock artists in particular). Record labels invest heavily in touring as a marketing tool for generating additional record sales, and artists often devote a tremendous amount of effort and time into traveling around the country or world on concert tours for the same reason. I have never heard of a music publisher providing or even contributing to tour support for an artist-writer or for artists who record other writers' work.
- <u>The Publicity Department</u> works to capture a larger "share of mind" for our artists by making sure the artist's story is told in as many media outlets as possible. One way this is accomplished is by educating the public about our artists through features,

interviews and reviews. The Publicity Department also arranges television appearances and organizes other events to promote artists and their music.

- The Sales Department develops retail marketing strategies, using merchandising material to help promote artists, and promoting in-store play and appearances. Sales Department staff are also responsible for monitoring and allocating the advertising expenditures made by various departments. The sales job has been made more difficult by the downturn in so-called "brick and mortar" music retail outlets. Not only are physical sales down, with venerable retailers such as Tower Records going out of business, but CD sales are shifting from specialized music stores to "big box" retailers such as Best Buy and Target. Now, in exchange for including a particular album in a store's advertising material, which is very effective for generating sales, retailers often demand some form of exclusive content that will only be sold in their stores. The Sales Department must work with the A&R Department and the artist early in the production process to develop special content, such as acoustic, live or extra tracks, to offer to different retailers. An additional benefit of offering such bonus material on physical products is that it may entice consumers to buy an entire album, rather than downloading single tracks online. We also include special content in online bundles in order to give consumers an incentive to download more than individual tracks. All of this additional content is expensive to produce and, depending on the nature of the content, may increase our mechanical royalty obligation. Publishers rarely agree to grant gratis or reduced rate licenses for such content, requiring record companies to shoulder all the burden of such increased costs, all so the records can be sold at the discounted wholesale prices the big box retailers demand.

- The Video Promotion Department coordinates use of videos to promote sales of recordings. Videos are one of the most significant but expensive forms of marketing albums, and recently a revenue opportunity. Once a track (or tracks) from an album has been identified for release as a single, we work with the artist to select the most appropriate production companies, directors, and other essential components for the video. We also coordinate the production, to ensure that it is consistent with the overall creative vision we are pursuing with the artist. Once completed, promoting the video is very important for the success of the album, because it is difficult to have a successful album without video exposure on MTV, VH1 and their progeny. However, although videos are made for most of our artists, there is no assurance the video will be seen at all or in sufficient "rotation" to make an impact on consumers. The Video Promotion Department not only advocates for videos to be seen, but also creates other opportunities for artists on video outlets, such as performances and interviews. Together with the New Media Department, the Video Promotion Department also promotes the inclusion of videos on the Internet.
- The Radio Promotion Department is responsible for ensuring that artists' music has the chance to be heard on radio, in coordination with other local marketing efforts (e.g., in-studio interviews, concert appearances, promotions). The hope is that once the music is heard, audiences will respond, airplay will increase, and the public will be motivated to purchase the album. This process has been made increasingly difficult because of consolidation and concentration in the terrestrial radio business. Decisions

on what to play are made more and more often in national corporate offices rather than DJ booths, and locally owned independent radio stations, which were generally more willing to take greater risks on new artists, are disappearing. In spite of the changes in the business, however, terrestrial radio play remains an important predictor of success for any given artist.

- The New Media Department is responsible for creating artist and fan websites, sending "e-mail blasts" to the artist's fans, ensuring artists and their music are well represented on Internet portals and blogs, setting up live Internet concerts, and otherwise utilizing the Internet to gain exposure for artists. As a result of the consolidation of radio and decline in physical sales, it has become increasingly important for record companies to use these new media as a major component of their marketing strategy. Many new recordings now have multiple release windows through digital distribution channels. For example, we will often release a mastertone or an exclusive digital track several weeks before the release of the CD in order to create a buzz. The digital market also provides new advertising techniques, such as featured placement on digital music services. As technology is evolving, so too is the new media marketing function. Each technological advance opens up new methods for exposing artists to the public and new costs for coordinating that exposure. Even though only a few years ago New Media was just a small fraction of overall marketing expenditures, the percentage has been increasing rapidly.

Once again, music publishers make no financial or human resources contributions to this critical stage of the process of turning recorded songs into revenue-producing products. The publisher's role is merely as a clearinghouse for permission - or withholding permission and all too often impeding promotional activities that we believe will generate more sales and more revenue for both of us. For example, one of today's great promotional opportunities is being featured on Apple's iTunes Music Store as the free download of the week. iTunes draws millions of music fans each week. Almost nowhere else can a recording get that level of concentrated exposure to people who buy music. However, when we need to get a publisher's permission to provide free downloads as part of an iTunes promotional effort, which typically needs to happen on a very tight timetable, we very often do not get a timely response, or get "no" for an answer. In some cases, as a result of a publisher's refusal to clear a free download, we have had to make the difficult choice of paying publishers on tracks that we give away. We therefore have the "double whammy" of having to give away our music to effectively promote it in this difficult market, and having to pay the publisher in spite of the fact that we don't get paid.

D. Manufacturing and Distribution

The final steps in making creative recordings available to the public are manufacturing and distribution. The Finance Department helps set pricing for the album and works with the Sales Department to determine how many units to ship, both initially and for subsequent shipments, and what kind of discount policy to set.

Physical products such as CDs must be manufactured, which includes stamping the discs and printing the packaging material. They also must be stored, packed and shipped. There also are returns, which can often be substantial and slow to come in, creating complex accounting issues.

Electronic distribution involves different processes and cost categories, but no less expense. It is a common misconception that the lack of a physical product means the lack of costs. Entering the online market has required a huge capital investment, as well as recurring costs of preparing recordings in numerous formats for different online distribution channels, preparing associated metadata, file storage, transmission to distributors, and so on. In our case, a significant part of the dedicated investment in this area has been made at the Warner Music Group corporate level, but transitioning to the digital world also taxes departments whose work covers both physical and digital rights and exploitation, such as our department (Business & Legal Affairs), finance and royalties.

Warner-Elektra-Atlantic Corporation ("WEA") and Alternative Distribution Alliance ("ADA") act as distributors for all of WMG's United States labels, as well as for many smaller, independent labels. WEA and ADA are responsible for physical and digital distribution of albums and related products. For physical products, WEA has an extensive distribution network and handles warehousing, shipping and inventory control. It also has a large sales force, whose efforts are supplemented by Atlantic's sales staff.

WEA helps to manage the account relationships with retailers and ensure that quality products are manufactured and shipped on a timely basis. WEA also handles reorders and ensures retail customers have adequate stock, as well as taking care of the billing and credit relationship with customers. In the case of electronic distribution, our distribution companies have account relationships with the major digital music services, as well as mobile carriers and ringtone providers. They are responsible for encoding and delivering the digital masters to these providers and administering the collection of revenues.

WEA and ADA typically collect from their customers after obtaining orders and distributing sound recordings on Atlantic's behalf. The distribution companies generally receive a percentage of the wholesale price as distribution fee.

Music publishers are not involved in the manufacturing and distribution portions of the record-making process and do not bear or contribute to any of the associated costs.

E. The Risky Business of Producing Records and How Recent Circumstances Have Intensified Those Risks.

The high level of activity and investment by record companies in every stage of the creation of an album results in a correspondingly high level of risk for them as well, because far more newly released albums fail each year than succeed. Recent changes in the recording industry, including declining overall and per album sales and the increasing rarity of "hits," as well as the transition to electronic distribution, which tends to emphasize single track purchases over full album purchases, have only increased the amount of risk to record companies. Music publishers, on the other hand, are not confronted with nearly the same level of risk, and their comparative position of security has not been placed in peril by recent industry changes.

F. Risks in General

The risk to record companies in creating records is considerable. It is a generally accepted industry truism that on average, only one out of every ten new artists signed to major record labels will have a successful album in terms of making a profit for the label. (I am proud of the fact that Atlantic's batting average has recently bettered the industry average, but no major record company over the course of time has ever had more hits than misses.) Therefore, as mentioned above, it is very common for record companies never to recover all the money they spent on creating and marketing an album, let alone make a profit. Nevertheless, if a record is to have a chance at succeeding, Atlantic must approach it as if it will succeed. We do our best to estimate how well an album will sell. Based on a financial analysis, we determine how much of an advance to provide, production and promotion budgets, and so forth. If an album sells less than 500,000 copies, we will often lose money on the project, particularly in the urban and pop genres. But even if an album sells 800,000 copies, if we based our financial plan on selling a million albums, it will still be a loss to us. The same record, however, will be a win for the music publishers and songwriters, because they are paid for every record sold, and we would pay on the order of $800,000 in mechanical royalties for such a release.

A successful first album by a new artist is the "holy grail" of the record industry. Yet, the truth is that a successful first album does not by any means ensure a successful second album; the truth is that the risk begins anew with each album released by an artist. An artist might have one successful album and then release a subsequent one that completely fails to catch on with consumers. Artists therefore risk their careers with each new release. This has become even more of a problem in recent years. At one time, once an artist was "broken" (or had become a success), we could depend on the artist to have a number of successful albums, and the risk in releasing later albums from an established star was relatively low. Today, however, breaking a new artist does not mean success beyond the release in question, and many artists only release one successful album. And if we are fortunate enough to break an artist, we are often faced with demands to renegotiate the artist's recording contract to reflect their growing stature as artists. The odds of a follow-up album to a successful album doing well are still better than for all albums in general, so record companies often invest more in marketing such releases in the hope that they can be made even more lucrative than the initial album. If that is not successful, the losses can therefore be even worse than with first albums.

Songwriters and publishers do not face similar risks. The risk to songwriters and publishers is that the limited time invested in the creation of a song will not result in an immediate financial reward if a release generates few sales (although a good song still might do well in the long run if covered by one or more artists). While this is a legitimate worry, an album that sells poorly will not ruin their careers, as it may for the artist, or cause them to lose substantial sums of money, as it will for the record company.

G. Higher Risks from the Decline in Sales and Rarity of Hits

As described in the testimony of David Teece, there has been a dramatic decline in industry sales and revenue in recent years. These conditions have several causes, including unprecedented levels of physical and online piracy, competition from other forms of entertainment (such as DVDs and video games), retail consolidation, radio stations and music video networks such as MTV playing fewer recordings, and displacement of physical album sales by single track download sales.

Even more telling than these statistics is that "hit" records are becoming less big and less prevalent. There are not nearly as many high selling records today as there were ten years ago. Of the new albums released in 1998, 252 had been certified as Gold (meaning they had sold over 500,000 units) by RIAA by the end of 1999, 131 albums as Platinum (over one million units sold), and 47 albums as Multi-Platinum (over two million units sold). Of the albums released in 2004, on the other hand, RIAA had certified only 198 albums Gold by the end of 2005, 94 albums Platinum, and 35 albums Multi-Platinum. In today's market, therefore, it is necessary to adjust downward our expectations for artists even after they are successfully "broken" and to redouble our efforts to achieve the hits that make our business possible. It also places pressure on our company to find other sources of revenue from the artist and the artist's music, including sales of mastertones, videos and other content. Once again, we find that often the most difficult part of launching this new content is neither the cost of making it nor marketing it, but the process (and cost) of getting it cleared by publishers.

The decreased incidence of hits has had a very negative effect for record companies that goes well beyond the harm caused by lower total sales. The high unit sellers are most profitable, because the percentage of the sales price spent on promotion is generally lower. Fewer hits means fewer profits. As stated above, many albums just start to become profitable for a major record company when they go Gold, and for many albums in the pop, R&B, and hip-hop genres in particular, the record company may not make a profit until they are approaching Platinum. Major record companies depend on big Multi-Platinum hits to compensate for the losses suffered on the vast majority of their releases.

To maintain profitability, we have cut costs to the bone. But to provide the threshold level of support that our artists need to have a fair chance to realize their potential, and to maximize our chances of having a profitable release, there is a certain level of marketing investment we simply have to make. Unfortunately, that level is remaining constant while our sales are dropping. In the past, once an album became popular enough and achieved a certain level of sales, often around the Platinum level, the momentum of popularity would often keep sales going to the Multi-Platinum level without the need for the record company to continuously market the album at the same high level of expenditure. In the current market, however, albums that manage to approach Platinum often fail to go beyond it. And big hits never seem to achieve the kind of sales momentum that lets us significantly scale back our rate of spending. Today we must push hard and invest a lot to eke out those additional sales. If an album shows possibility by selling perhaps 700,000 copies, rather than ratcheting back, we will often invest additional marketing dollars to try to push the record to the Platinum level. But if the album fails to reach the desired level, those additional expenses can cause us to lose money on the release despite the fact the album reached well above the Gold level.

Although Atlantic has a solid history of identifying successful artists, that is no longer enough. Today it is not just about wins; success depends on *great* wins. In contrast, publishers and writers will have been paid royalties on every album sale, even if the record company ends up losing money on a release because of its efforts to aggressively market it. And in contrast with the record company, the publishers and writers will have few, if any, costs to recover from that immediate stream of royalties.

Another disturbing consequence of the market trends I described is a steep decrease in "catalog" sales (i.e., sales of recordings other than new releases). Record companies have historically relied on catalog sales for extra revenue because they require relatively little marketing investment and are therefore quite profitable. However, in recent years this has no longer been the case. SoundScan data shows that Atlantic's catalog sales declined from approximately [redacted] units in 2000 to [redacted] in 2005. Data from this year shows that the trend is continuing with only [redacted] catalog units sold through October 15, 2006. Moreover, because there are only a limited number of retail outlets that are still willing to carry catalog albums, we now have to slash our wholesale prices or provide extreme discounts to even get our catalog albums in stores, which drastically cuts the margins we receive on the catalog albums. It remains to be seen how much of the decline in physical catalog sales can be made up online. Again, publishers and writers have been insulated from this phenomenon, because they receive their mechanical royalties based on the number of songs sold. However, if the larger trends affecting catalog sales persist, maintaining a system of mechanical royalties at a high cents rate will eventually make catalog sales unprofitable for record companies.

H. Increased Costs and Risks in Transitioning to the Digital Marketplace

The transition to distribution by means of electronic transmission has also increased the costs and risks of the recorded music business. Format changes in the past, such as from LP to CD, did not affect our basic business model or distribution chains. You may even remember when the plastic CD "jewel box" was packaged in a cardboard box called a "longbox" to fit in retail store fixtures designed for LPs. The transition from "longbox" to jewel case was relatively easy. The change to electronic distribution, however, is a sea change - every aspect of the record business has changed as we distribute recordings through many different outlets in many different formats.

Distributing music in electronic formats is requiring a huge investment in infrastructure as well as higher recurring costs. I've described above WMG's investment in digital infrastructure, as well as all the things Atlantic does to distribute recordings in new media. For example, it used to be that when we released an album, we produced only a handful of products – the album itself, possibly a few singles, and a video. Today, we produce download single versions of every track in different formats, as well as mastertones in different lengths and different digital formats for each carrier, and various extra tracks such as live or acoustic versions. This is all in addition to producing the physical product, which although declining, is still the industry's dominant format. All told, we might have over [redacted] different products associated with an album. (For the recent release of our artist T.I.'s album "King", we had [redacted] different products available.) The marginal cost of producing any individual associated new media product is not large, but because there are now so many formats and sales volumes are generally low, this represents a significant increase in total cost per release and sales often do not recover that cost.

At the same time our electronic products face obvious and direct competition from illegal peer-to-peer services, which has kept prices and sales low. As this marketplace continues to emerge, it is by no means clear what prices for different kinds of offerings will ultimately be sustainable. Thus, at the present, we are spending to produce more types of products than ever before, and build and maintain channels to distribute them in more different ways than ever before, all to sell relatively low levels of each product at relatively low prices, making our margins on each product lower than ever before.

I. A Case Study

Jewel was originally signed to Atlantic in 1993. She released her first album, titled "Pieces of You," in 1995 and it achieved sales in the United States, as measured through SoundScan, of 7.3 million units (a unit volume which was very successful by the standards of the time, but is virtually unachievable today). Her second album, titled "Spirit," was released in 1998 and achieved U.S. sales, as measured by SoundScan, of 3.7 million units. Three albums followed in 1999, 2001 and 2003, and scanned 1.1 million units, 1.6 million units and 762,000 units, respectively. Her most recent album, titled "Goodbye Alice in Wonderland," was released in 2006 (the "2006 Album") and has achieved sales in the U.S. as measured by SoundScan, of 288,000 units. (While that album continues to sell in small amounts each week, it will in all likelihood never make it much past the 300,000 mark.)

For purposes of this exercise, I will be comparing the P&L of Jewel's 2006 Album against her 2003 Album titled "0304" (the "2003 Album"). It should be obvious that the financial results of Jewel's 2006 Album would be worse than her 2003 Album, given a drop in sales from approximately 762,000 units to 288,000 on the more recent release. What I believe may not be so obvious, and what may be somewhat surprising when examining the numbers more closely, is how the level of investment required to create, market and sell albums in the current marketplace needs such a high level of sales in order to generate profit.

1. A&R Costs

A&R costs, inclusive of all recording costs and advances to the artist, for Jewel's 2006 Album were approximately [redacted]. That number was [redacted] for the 2003 Album. The levels of spending for both albums are commensurate with what it typically costs to record a pop album by an established artist, with multiple producers and guest artists. While these costs are controllable to some degree, our experience is that certain types of albums tend to fall into a range, and the costs for both of these albums are within the "normal" range for this type of album.

2. Marketing Costs

In the modern record business, marketing costs remain the biggest variable of "controllable" spending, and, as discussed above, we must do our best to base our marketing spend on our unit projections. In marketing the 2006 Album, we had what our A&R people believed was a very good album, and we had early indications from radio play in advance of releasing the album that the album had great sales potential. These factors, taken together with the strong sales history of the artist, led us to design a marketing plan appropriate to the status of the artist and the potential of the project. At the same time, when comparing the prospects of the 2006 Album to the results of the 2003 Album, we knew that we needed to control costs, because the marketplace in 2006 was simply not as robust as the marketplace in 2003. We had recent experience with other artists whose relative popularity (measured by radio play, touring and other factors) had not declined, but whose record sales nevertheless suffered from the effects of piracy and other factors.

A total of [redacted] was spent on marketing the 2003 Album, driven largely by the cost of music video production, radio promotion and cooperative advertising. For the 2006 Album, we were able to reduce those production, promotion, and advertising line items, resulting in a [redacted] reduction in marketing spending compared to the 2003 Album, for a total cost of [redacted]. Any attempt to further reduce those marketing costs, which might have been prudent in hindsight, would have resulted in less exposure or lower quality materials than an artist with Jewel's past success deserved. For example, while we were able to bring the cost of music videos down from [redacted] for the 2003 Album to [redacted] for the 2006 Album, attempting to cut that amount further might not have given the artist a video of the quality that her fans have come to expect.

We are faced with this dilemma project after project; sales have slipped, yet in order to properly market our artists, we simply must provide a threshold level of support that gives our artists a fair chance to realize their potential. And our employees, who generally entered the music business because of their love of music and respect for artists, want nothing more than to provide this support. I am proud to say that I believe our company does an incredible job of stretching our marketing dollars, of finding alternate means of supporting our artists, and of trying to meet the challenges with ingenuity and hard work. However, it has become increasingly difficult to achieve sales levels that allow us to recapture even our threshold marketing investment and still turn a profit.

3. <u>The Results</u>

Jewel's 2006 Album "sold through" only 288,000 units in the U.S., as measured by SoundScan. (We shipped 419,000 units, but the excess units were largely returned by retailers for full credit because they were not selling, a standard practice when shipments exceed retail sales.) The 2003 Album had sales measured by SoundScan of 762,000 units, and that album earned over [redacted] in profit for the label. The 2006 Album lost Atlantic nearly [redacted]. While selling 288,000 units of an album remains no small feat in this marketplace, it was simply inadequate to cover the costs of making and appropriately marketing that album.

CONCLUSION

The sea change that is underway in the recording industry requires a change in the mechanical royalty rate and rate structure. Today's mechanical royalty rates are out of line with the investments and risks of record companies relative to writers and publishers, as well as with historical rate levels.

I've described what it takes to take a raw song, polish it, turn it into a creative recording, and promote and distribute it so that it will reach the public. It is unquestionable that record companies and artists make tremendous and indispensable creative and financial contributions at every stage of the process. It is also indisputable that record companies bear a higher degree of risk than any other participant in the process. Both their investment and risk are grossly out of proportion to the contributions of writers and publishers to the product made available to the public. Yet it is record companies that give commercial life to songs and open up all kinds of income possibilities for writers and publishers. In view of those facts, it is simply unfair that as we have faced declining sales, declining profitable hits, increased costs, and falling prices, mechanical royalty rates have just gotten higher.

A percentage mechanical royalty at a reduced rate would be in the best interest of the whole music industry. With a percentage rate structure that shared risks more equitably, gave us predictable margins across the full range of formats and gave us more flexibility, we could experiment with new business models, pricing strategies, bundled offerings and other possibilities for increasing record sales. With a rate more in line with the relative contributions of record company and publisher, we would have greater incentive and opportunity to invest in the creation of new recordings. Both changes could lead to growth rather than contraction in the music industry, expanding the pie for all of us, and more opportunity for writers and publishers to sell their music and generate income from other sources such as performance and synchronization.

I declare, under penalty of perjury, that the foregoing testimony is true and correct to the best of my knowledge.

Michael Kushner

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